Economics and Sociology
Occasional Paper No. 1758

NOTES ON THE RECENT ECONOMIC DEVELOPMENT PERFORMANCE OF BRAZIL: THE POLICY CHALLENGES FOR THE FUTURE

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May, 1990

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Abstract

The Collor reforms in economic policy represent a novel approach to stem hyperinflation, particularly in freezing savings accounts beyond a minimum level for 18 months. While this drastic reduction in the velocity of money has had a less regressive impact on the population (in the short run) than more conventional deflationary measures, it has clearly damaged the long run potential for domestic savings mobilization and financial intermediation. Furthermore this will gain little in the long run unless the government drastically reduces its public sector borrowing requirements. Privatization, public sector layoffs, and attention to a more depreciated real exchange rate, the removal of quantitative restrictions on imports and a reduced uniform tariff structure are all necessary to restructure the economy for the future.

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THE SETTING:

The current development scenario in Brazil is full of ambiguities and uncertainties. This is certainly characteristic of the country's policy stance throughout the decade of the 1980s. Before discussing the challenge of the early nineties it is useful to review the growth performance and policy issues of the past decade, particularly the last half of the decade.

Per capita growth was stagnant over the past decade 1981-89 (-0.4 percent per year). The country was no better off in 1989 than it was at the beginning of the decade. While this is a dismal record in comparison to previous decades, it doesn't compare badly to most Latin American countries over the 1980s. However, this generous interpretation of the relative performance of Brazil vis-a-vis the disastrous record of Peru, Argentina, Venezuela, Nicaragua, and others is hardly a complimentary reference group for Brazilians to feel comfortable about.

The important reference point is the relative standing of Brazil at the end of the 1970s when it was considered one of the better performing countries in the LDC world facing the challenges of the post-1973 oil crisis. By the end of the 1980s Brazil has slipped badly in the ranking of countries that have worked out their development potential to face the 1990s. The main problem is that the country has not been able to marshall sufficient political will and social consensus on an appropriate set of economic policies to face and overcome the disequilibrating forces of a rapidly changing world economy and successfully negotiate itself out of the debt overhang in which it finds itself today.

Throughout the 1980s the country has been unable to undertake any meaningful economic liberalization that could create more efficient and self sustaining growth. Trade policy reforms have been half hearted and backsliding. Tariff and exchange rate measures have been compromised by a growing list of quantitative restrictions on imports (QRs) that have arbitrarily introduced a wide range of distortions into the domestic economy. More recently the real exchange rate has been deteriorating with a consequent decline in export performance from mid 1989 up to March 1990. Brazilian manufactured exports have proven competitive in world markets, but it becomes more and more difficult to sustain this performance in the face of a declining real exchange rate. More important yet is the need to maintain a consistent policy stance on the real exchange rate over time to ensure a long run sustained growth in exports. The stop and go syndrome with exchange rate policy is counterproductive for long run growth.

The financial sector has also experienced little liberalization. Selective credit programs with varying degrees of subsidy have characterized the 1980s. On some occasions, for certain loans, real rates of interest can be quite high, for other loans low or negative in real terms. The highly fluctuating real interest rate environment in this inflationary setting increases risk, shortens loan term structures, segments markets, and weakens the role of financial intermediation in allocating resources efficiently. The weakness of the financial sector is also associated with the "crowding out" syndrome that characterizes the government's increasing access to the capital markets to finance its operational deficit. All this leads to a distorted and wide spread in the structure of real rates of interest in financial markets.

The core problem in Brazil grows out the rising share of internal debt in the Brazilian economy. Brazil in effect, has substituted internal debt for taxes. Hence it is possible for policymakers to claim that the Central Governments fiscal accounts (i.e. the primary balance) are in balance, namely tax revenues equal central government expenditures. However, there are many other budgets in Brazil where the real action occurs, state and local government budgets, public enterprise budgets, the monetary budget, etc. In the end the government incurs a high public sector borrowing requirement to finance through the issue of government notes the comprehensive deficit in the total public sector. In terms of the operational balance (i.e. in which the interest cost on the internal debt is included as a part of government expenditures) the government's deficit has been rising rapidly. The resort to this mechanism has shortened the average term length of public debt to little more than 24 hours. The interest on this internal debt is rapidly rising as a share of GDP. And, of course, this rapid issue of internal debt generates an increase in the money supply feeding inflation.

Another consequence of this action is the increased inefficiency this introduces into the economy. This occurs in three ways. First, many of the projects financed through this internal debt have a low rate of economic return. The pro-alcohol program, the Brasilia Maranhao railway of the Sarney Administration, the Nuclear plant investments, the incredibly expensive Rio and Sao Paulo subway systems, and many others could never pass a rigorous benefit cost test despite the billions poured into these ventures. Moreover these are not one shot deals. They create recurrent costs that act as a persistent drain on public resources through time.

Secondly, the wide range of subsidies granted to selected private sector activities are in effect subsidizing inefficient production, otherwise they would not need the subsidies. These subsidies can either be fiscal subsidies (tax exemptions or write-downs which add to the deficit) or credit subsidies granted through the monetary budget (which in the end require an increase in internal debt and the money supply).

Thirdly, the remaining private sector activities not blessed with privileged access to public sector resources suffer from the "crowding out" syndrome for working capital associated with the growing share of public sector debt financed through the capital markets. This action increases the cost of credit for the unprotected private sector and creates a cost push inflationary element into this non-priveledged private sector activity. The combination of all three elements described above have led to an inefficient allocation of resources and have circumscribed the role of an efficient and resilient private sector in the development process.

Liberalization, deregulation, and privatization are not popular ideas in many political and professional circles in Brazil. The country has always shown a strong bias for a dominant state role in development. The recently created Constitution reflects this nationalist and populist sentiment with a large role for the state in many essentially unregulatable areas. Given this bias, it is not surprising to note that the political economy of liberalization has largely bypassed Brazil in the decade of the 1980s.

Many countries in East and Southeast Asia have engaged in substantial liberalization of their economies in the past decade. African economies are now facing this challenge and, of course, the Eastern European countries are the most recent adherents to this policy stance. In Latin America, Chile has long been a convert to these policies, but this example is always compromised in the eyes of most Brazilians due to the political framework within which it was implemented. Post-1988 Mexico, however, is probably the most interesting and relevant case for Brazilians to study with some interest.

The Mexican Connection

Mexico is a large country, as is Brazil, hence the import substitution bias has been a natural phenomenon. Indeed, Mexico insulated itself from a liberal trade regime to such an extent that it refused to join GATT until recently. A strong state enterprise sector also dominated Mexico's heyday of development with public sector enterprises in most of the same major capital and intermediate good sectors as in Brazil. In short, both countries have much in common in terms of size of market, industrialization and trade strategy, and state sector dominance in both the production of goods and services and in heavy corporatist regulatory traditions.

Yet from the middle 1980s to the present, and particularly from the post-1988 Salinas de Gortari regime onwards, Mexico has been rapidly dismantling its protectionist regime and state sector, and opening its economy to international competitive forces. By the end of 1990 all QRs will have been converted to tariffs and uniform tariff rates established between 10 to 15 percent. A competitive real exchange rate has been established with manufactured exports rising rapidly. The country has joined GATT and talks are continuing on creating a free trade agreement with the U.S., something that would have been unheard of five years ago. Public sector employment and subsidies have been drastically curtailed, tax reforms are being realized, and a growing number of state enterprises are being sold to private and foreign interests. These actions reflect a close parallel to many of the actions that should be undertaken in Brazil.

However, there is one important difference between the two countries, the institutional framework within which these actions have been taken. The unique national political culture of the PRI has allowed Mexico an institutional leverage to sustain unpopular economic measures over a sufficient period of time to reduce its operational deficit and begin to gain recovery in a radically altered policy regime. This leverage does not exist in Brazil which makes the future of the Collor Plan far more problematical.

The Collor Plan

1. The Collor Plan of March 1990 had to face the challenge of the lack of credibility growing out of previously failed stabilization programs. All Brazilian administrations have to engage in some degree of overkill to make up for this deficiency of past efforts to affect inflationary expectations quickly. The novelty of the Collor Plan lay in the freezing of savings accounts beyond a minimal limit for 18 months, a strategy hitherto never tried before. In addition the initial burden of adjustment fell on the wealthier segments of society, just the opposite of most conventional stabilization programs. This generated more popular support than is

customary for deflationary measures. The second round effect, however, will very likely spread to the working class as unemployment rises with the decline in economic activity growing out of the abrupt decline in the velocity of money circulation caused by the savings account freeze.

A strong negative consequence of this action is to permanently weaken the incentives for savings mobilization through the financial system. This is particularly unfortunate in light of the declining flow of external funding for Brazil's development and the growing weakness of tax measures to generate sufficient revenue to cover the fiscal deficit. Clearly the massive sale of state enterprises and cut-back in current expenditures (i.e., public sector employment) is needed to reduce the global deficit (i.e., the public sector borrowing requirement).

Finally, it is becoming apparent through the ensuing months of the Collor Reform, that special exceptions are being made to the savings account freeze, permitting firms to honor outstanding debts, tax payments, etc. In the end it is the individual middle class saver who will find no way of escaping the freeze, thereby bearing the burden of the reform. It is highly unlikely that the government will properly index the value of these accounts to offset inflation over the next 18 months. The net effect of this action will be a massive hidden tax on largely middle class savers.

2. A second important policy arena is the real exchange rate. Brazil has traditionally enjoyed a competitive export sector both in basic commodities (and their derivatives) and in manufactured products. However this competitiveness has always

had to overcome periodically overvalued exchange rates used to stem inflationary pressures. In the past, export subsidies have been used to offset this competitive disadvantage. More recently (from June 1989 to March 1990) the real exchange rate has appreciated close to 40 percent. The decline in export growth over this same period, especially in manufactured exports, reflects this gradual loss in competitiveness. Since March the Collor Plan has carried out a nominal devaluation of the new currency of roughly 20 percent. This roughly equals a similar real devaluation given little inflation during this period. However the effective exchange rate devaluation is much less once allowance is made for the removal of export subsidies in the Plan. More time will be needed before one can sort out the net effect of nominal devaluation, inflation and the change in the net subsidy position for Brazilian exports.

3. The net bias in the overall trade and exchange rate regime also depends on the overall effective level of protection which brings us to the third policy arena, <u>quantitative restrictions on imports</u> and the <u>tariff structure</u>. The Collor Plan includes a measure to convert QRs into tariffs but it would appear that no implementing action has been undertaken to date in this regard. This first step clearly has to occur before any liberalization can be launched on reducing the levels of effective protection through tariff reforms. With such a large number of QRs in place it is almost impossible to measure effective levels of protection through tariffs. A more aggressive policy of exchange devaluation could be pursued to substitute for the decline in protection through trade reforms. The advantage of a sustained

depreciation of the real exchange rate is that it does not discriminate against or among exports as does tariff protection.

4. However a more aggressive real exchange rate policy will add inflationary pressures through the higher cost of imports unless strong complementary action is taken to reduce the overall fiscal deficit in the operational balance (i.e. the budgetary balance that includes the interest cost on the internal debt as an expenditure in the government accounts). These actions require a shrinking role for the state in the economy through a sustained reduction in public sector employment, subsidies and the sale of more state enterprises and the dismantling of autarquias.

5. Privatization will not be an easy task in Brazil. Measures in this regard have been half-hearted to date. Some selective role for foreign capital is possible here, but any wholesale entrance of foreign capital into commanding positions in many state enterprises through debt-swap arrangements would be very unpopular in the present political environment. Yet the present state of the economy does not suggest that there is substantial private domestic capital available for this task. It has been reported that banks have been forced to buy government bonds to help carry out privatization measures. Banks presumably would pay for shares in the public enterprises through the sale of these bonds. This action is allegedly reinforced through a sliding scale eroding the value of these bonds through time thereby inducing their quick use to buy state enterprise assets. These measures are still imperfectly documented (at least to this writer) and therefore their impact on promoting the sale of state assets unclear.

Conclusions

No matter how packaged, a combination of relatively orthodox stabilization and liberalization measures are essential for Brazil at this time. The issue is not their initial adoption, but rather staying the course for a sufficient period of time to effectively reduce inflationary expectations, on the one hand, and promote a more efficient path of recovery on the other hand.

The two countries most ideally positioned to grow successfully in the 1990s are very likely Chile and Mexico. Chile for the past five years has recorded the highest rate of growth in Latin America. Moreover this growth has been associated with low inflation, a diminishing foreign debt and a rapid growing non-copper export sector. Moreover the new team of economic managers under President Alwin have stated they will not alter the basic parameters of economic policy established by the previous regime. Having said this however, it must be recognized that both these countries carried out a wide ranging alteration of their economic policy regimes within essentially a non-democratic political framework (or for Mexico a coercive consensus within a corporatist political structure). Brazil's unpopular measures will be undertaken within a substantially weaker set of political institutions and with substantially less consensus concerning the proper path for future development. Never has the political economy of reform ever been so dependent and vulnerable to the political dimension of reform.